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Trusts & Estates Department Alert

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PROPOSED LIMITATIONS ON GRATS; TAX ISSUES FOR MARRIED SAME-SEX COUPLES IN NEW YORK; SEC GUIDANCE ON FAMILY OFFICES

Proposed Legislation Imposing Certain Requirements on GRATs

On June 28, 2011, a bill was introduced in the U.S. Senate (S. 1286) that would impose additional requirements on transfers to grantor retained annuity trusts ("GRATs") made after December 31, 2010. The bill, like similar bills proposed in 2010 that did not become law, seeks to limit the ability to utilize GRATs as an estate planning strategy by requiring (i) a minimum GRAT term of ten (10) years, (ii) that during the first ten (10) years of a GRAT, annuity payments may not be reduced from one year to the next and (iii) that the value of the remainder interest of a GRAT at the time assets are transferred to it must be greater than zero. We note that this bill differs from the prior bills in that the effective date of prior bills had been the date of enactment, whereas the new bill would apply to transfers made on January 1, 2011 and thereafter.

A GRAT is an excellent technique to transfer wealth without gift tax, as long as the donor survives the trust term and the trust assets appreciate in value in excess of IRS interest rate assumptions. Now is a particularly good time to use GRATs because interest rates are at historic lows; the IRS interest rate applicable to GRATs funded in August 2011 is only 2.2%. A shorter trust term can be preferable in some cases because it reduces the risk of the donor's death during the trust term. Conversely, mandating a longer trust term increases the mortality risk and therefore reduces the attractiveness of a GRAT for older individuals. We will keep you updated on the status of the bill as it progresses through the legislative process.

Also, as discussed in prior alerts, charitable lead trusts ("CLTs") are a similarly efficient technique to transfer wealth at a potentially minimal gift tax cost while also satisfying your philanthropic objectives. There has been no legislation proposed that would restrict the efficiency of CLTs; however, like GRATs, now is a particularly good time to use CLTs given the historically low interest rates.

New York State Tax Department Issues Guidance on Marriage Equality Act

New York's Marriage Equality Act (A. 8354), signed into law by Governor Cuomo on June 24, 2011 and effective July 24, 2011, amends New York's Domestic Relations Law to provide that "[a] marriage that is otherwise valid shall be valid regardless of whether the parties to the marriage are of the same or different sex." On July 29, 2011, the New York State Department of Taxation and Finance issued guidance on the Marriage Equality Act and its consequences for New York state tax purposes, including personal income tax and estate tax, which are the taxes most affected by the Act.[1]

[1] See TSB-M-11(8)C, *The Marriage Equality Act*, and TSB-M-11(8)M, *Implementation of the Marriage Equality Act Related to the New York State Estate Tax*, New York State Department of Taxation and Finance, Taxpayer Guidance Division, July 29, 2011, available at www.tax.ny.gov.

Please feel free to discuss any aspect of this alert with your regular Milbank contacts or with any of the members of our Trusts and Estates Group, whose names and contact information are provided herein.

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Same-sex couples that are married as of December 31, 2011 and file personal income tax returns with New York state must elect a "married" status on their state income tax returns for tax year 2011. While the Marriage Equality Act is effective as of July 24, 2011, New York state will recognize a same-sex couple that is married as of December 31, 2011 as being married for all of 2011 for personal income tax purposes. Although same-sex marriages are now recognized under New York state law, same-sex couples must continue to file separate income tax returns for Federal purposes because of the Federal Defense of Marriage Act, which does not recognize same-sex marriage at the Federal level.

The estate of an individual dying on or after July 24, 2011 while married to a same-sex spouse is now eligible to claim a marital deduction and may make a qualified terminable interest property (QTIP) election, in each case for New York state estate tax purposes. As with personal income taxes, because of the Defense of Marriage Act, the estate will need to file its Federal estate tax return on a non-married status basis.

Finally, same-sex married couples will be able to split gifts made on or after July 24, 2011 by one spouse to a third party so that the gift is considered made one-half by each spouse for New York state estate tax purposes.

We would be delighted to discuss with you the Marriage Equality Act's consequences and changes that may be made to your existing estate planning documents in light of the new law.

<u>SEC Adopts Final Rule Defining "Family Offices" under Investment Advisers Act of 1940</u>

The U.S. Securities and Exchange Commission (the "SEC") has adopted a final rule defining "family offices" under the Investment Advisers Act of 1940 (the "Investment Advisers Act"). In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") eliminated the private adviser exemption that family offices previously relied on to be exempted from registration under the Investment Advisers Act, effective July 21, 2011.[2] At the same time, the Dodd-Frank Act amended the definition of "investment adviser" under the Investment Advisers Act to exclude "family offices, as defined by rule, regulation, or order of the [SEC]," from regulation under the Investment Advisers Act.[3]

On June 22, 2011, the SEC issued rule 202(a)(11)(G)-1, which provides the definition of "family office" for purposes of the Investment Advisers Act and is effective August 29, 2011.[4] Now, in order to qualify for exemption from the Investment Advisers Act, a family office must generally satisfy three conditions: (i) the family office must provide investment advice only to "family clients"; (ii) family clients must own, and family members or entities must control, the family office and (iii) the family office may not hold itself out to the public as an investment adviser.[5] For purposes of the rule, "family clients" are defined as any family member, any former family member, any key employee, former key employees (subject to certain limitations), the estate of any of the foregoing, charitable organizations funded exclusively by family clients, certain trusts of which family clients are the sole grantors or current beneficiaries and certain other trusts and entities described in the rule.

The final definition reflects the marching orders of the Dodd-Frank Act, which stated that the rules issued by the SEC should provide for an exemption for family offices that "is consistent with the previous exemptive policy of the [SEC]."[6]

<u>Reminder to Utilize Your Increased Gift and GST Tax Exemption</u>

As a follow-up to our February 25, 2011 alert, please be reminded that through December 31, 2012, the gift and generation-skipping transfer ("GST") tax applicable exclusion amount is increased to $5 million (reduced by the amount of any lifetime taxable gifts made), indexed for inflation in 2012. We would be pleased to discuss with you methods by which you can make optimum use of the new exemption while it remains in place.

[2] *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111-203, § 403 (2010).
[3] *Dodd-Frank Act* § 409(a).
[4] *Family Offices*, Investment Advisers Act Release No. IA-3220 (June 22, 2011) [76 F.R. 37983 (June 29, 2011)], adopting rule 17 CFR 275.202(a)(11)(G)-1.
[5] *Id.* at 37984.
[6] *Dodd-Frank Act* § 409(b).

Statement About Circular 230

Recent amendments to a Treasury Department regulation, known as Circular 230, require lawyers and accountants to follow strict rules in issuing a written statement about a Federal tax issue. The most onerous rules of compliance under §10.35 of the Circular involve written advice about so-called Listed Transactions, arrangements that have tax avoidance as their principal purpose and what are called Marketed Opinions. We do not believe any issue discussed in this memorandum relates to a Listed Transaction. We believe the tax benefit sought is consistent with the Internal Revenue Code of 1986 as amended (Code) and Congressional purpose. That means the principal purpose is not tax avoidance. We also believe no issue discussed herein is a significant Federal tax issue – meaning that we believe the IRS does not have a reasonable basis for a successful challenge on the overall Federal tax treatment of the issues discussed in this memorandum. That means we do not think this memorandum must comply with §10.35 of the Circular. Nevertheless, we add the following statements to ensure compliance with said §10.35. Notwithstanding these statements, we believe the conclusions reached herein are correct.

1. The written advice contained in this memorandum is not intended or written by us to be used, and it cannot be used, by any taxpayer for the purpose of avoiding penalties.
2. No one may use any part of this memorandum in promoting, marketing or recommending an arrangement relating to any Federal tax issue to any taxpayer.
3. Nothing herein shall be construed to impose a limitation on disclosure by any person of the tax treatment or tax structure of any transaction that is addressed herein.

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